Office of Chief Counsel
Internal Revenue Service

memorandum

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JMCascino

date: NOV 29 2000

to: Revenue Agent Mark Miller
Champaign, Illinois P.O.D.

from: Associate Area Counsel, SBSE

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subject: [redacted]
Taxable Years [redacted] and [redacted]
I.R.C. Sec. 6501(e) - Abusive Trust Cases
Earliest I.R.C. Sec. 6501(e) S.O.L.: [redacted]
Request For Advisory Opinion

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This memorandum is in response to a Request For an Advisory Opinion received from Revenue Agent Mark Miller via E-Mail on October 18, 2000.

QUESTION PRESENTED

1. Under the facts set forth below, whether potential deficiencies in income tax due from [redacted] and [redacted] (hereinafter collectively referred to as ("the Taxpayers") for

the taxable years [redacted] and [redacted] may be assessed and collected within the six year period of limitations set forth in I.R.C. § 6501(e). The resolution of this question depends upon whether omitted income in excess of 25% of the income properly includible on the Taxpayers' return for each of the taxable years [redacted] and [redacted] should not be taken into account for purposes of determining whether there has been an omission of income in excess of 25% of properly includible gross income within the meaning of I.R.C. § 6501(e)(1)(A) because disclosures on the Taxpayers' returns and/or returns of related abusive trusts were adequate to apprise the Secretary of the nature and amount of the omitted income within the meaning of I.R.C. § 6501(e)(1)(A)(ii).

CONCLUSION

1. In our opinion, the disclosures on the Taxpayers' returns and the returns of the related abusive trusts were not adequate to apprise the Secretary of the nature and amount of the omitted income within the meaning of I.R.C. § 6501(e)(1)(A)(ii) and, accordingly, the potential deficiencies in income tax due from the Taxpayers for the taxable years [redacted] and [redacted] may be assessed and collected within the six year period of limitations set forth in I.R.C. § 6501(e).

FACTS

You have recently completed the examination of the U.S. Individual Income Tax Returns (Forms 1040) of the Taxpayers for the taxable years [redacted] through [redacted]. The Taxpayers cooperated fully with your examination for these years. Your examination revealed that the Taxpayers omitted income for each of the taxable years [redacted], [redacted] and [redacted] as a result of their use of an abusive trust scheme. The Taxpayers are in agreement with your proposed audit adjustments and resulting deficiencies in income tax for the taxable years [redacted], [redacted] and [redacted] and have indicated a willingness to enter into a standard abusive trust closing agreement for the taxable year [redacted] and subsequent taxable years. The standard abusive trust closing agreement provides that the trust entities are shams and that the income reported by such trusts is taxable to the Taxpayers.

During the course of your examination, you learned that the Taxpayers first began utilizing the abusive trust scheme during the taxable year [redacted]. You have obtained the Taxpayers' returns and related trust returns for the taxable years [redacted] and [redacted]. Your review of the Taxpayers' returns and related trust returns for the taxable years [redacted] and [redacted] indicates that gross income in excess of 25% of the Taxpayers' gross income reported on their individual return for each of the taxable years [redacted] and [redacted] was omitted from each individual return and improperly reported on the returns of the related abusive trusts.

During the taxable years [redacted] through [redacted], [redacted] was engaged in the business of farming. For each of the taxable years [redacted] through [redacted], gross income from [redacted]'s services as a farmer was reported on the U.S. Fiduciary Income Tax Return (Form 1041) of the [redacted], [redacted], Director ("[redacted]"). [redacted] informed you that for the taxable year [redacted] and prior taxable years, [redacted] reported his farm income on Schedule F of the Taxpayers' individual returns.

1. Disclosures on the CBT returns

The [redacted] return for each of the taxable years [redacted] and [redacted] includes a Schedule F upon which the income and expenses of [redacted]'s farming operation are reported. The CBT Schedule F identifies the name of the business as "[redacted]" and the product as "[redacted]". Also reported on the [redacted] returns are minor amounts of interest income. The total gross income amounts reported on the [redacted] returns were $[redacted] and $[redacted] for the taxable years [redacted] and [redacted], respectively (including gross farming receipts plus interest income). Labor expense in the amounts of $[redacted] and $[redacted] was reported on [redacted] returns for the taxable years [redacted] and [redacted] (small amounts in comparison to gross income). The net farming income amounts reported on the [redacted] returns were $[redacted] and $[redacted] for the taxable years [redacted] and [redacted], respectively. The results of the [redacted]-[redacted] examination revealed that the income and expenses shown on the [redacted] returns were largely correct (except that the amounts should have been reported on the Taxpayers' returns) and, therefore, you expect that the results will be similar with respect to income and expenses reported on the [redacted] returns for the taxable years [redacted] and [redacted].

Each of the [redacted] returns report that the net income of the [redacted] returns is distributed to the [redacted], [redacted], Director ("[redacted]"), the beneficiary of the [redacted]. The address and TIN of the [redacted] are shown on the Forms K-1 of the [redacted] returns. The box for "Simple Trust" is checked on each of the [redacted] returns.

2. Disclosures on the [redacted] returns

The [redacted] reports the flow-through income from the [redacted] along with some interest income. The flow-through income reported by the [redacted] is reported on Schedule E of the [redacted] returns and the [redacted] returns clearly identify (by name and FEIN) the [redacted] as the source of the income.

For each of the taxable years [redacted] and [redacted], the [redacted] deducted fiduciary fees paid to the Taxpayers in the amount of $[redacted]. For each of the taxable years [redacted] and [redacted], the [redacted] also paid and deducted return preparation fees of approximately $[redacted] per year and medical expenses (you assume of the Taxpayers) of approximately $[redacted] to $[redacted] per year.

The [redacted] returns claim charitable contributions in the amounts of $[redacted] and $[redacted] for the taxable years [redacted] and [redacted], respectively. Schedules attached to each of the [redacted] returns for the taxable years [redacted] and [redacted] clearly indicate that these amounts were paid to another trust--[redacted] ("[redacted]"). For each of the taxable years [redacted] and [redacted], the [redacted] filed Form 990-PF and reported the charitable contributions received and the amounts actually paid to valid charities. The amounts paid by the [redacted] to actual charities were much less than the amounts received by the [redacted].

The remaining income in the amounts of $[redacted] and $[redacted] for the taxable years [redacted] and [redacted], respectively, was eliminated by the Income Distribution Deduction. Each of the [redacted] returns report that the net income of the [redacted] returns was distributed to the Taxpayers, the beneficiaries of the [redacted]. The address and TIN of the Taxpayers are shown on the Forms K-1 of the [redacted] returns. The box for "Complex Trust" is checked on each of the [redacted] returns.

3. <u>Disclosures on the Taxpayers' returns</u>

The fiduciary fees amount of $[redacted] which was deducted on each of the [redacted] and [redacted] returns was reported as "[redacted]" on Schedule F of the Taxpayers' return for the taxable year [redacted] and as "Other Income" on page one of the Taxpayers' return for the taxable year [redacted]. On Schedule F of the [redacted] return, the Taxpayers also reported Agricultural Program payments in the amount of $[redacted] (for which the Taxpayers had been issued a Form 1099), but reported no grain sales. No agricultural program payments were reported on the Taxpayers' [redacted] return. The amounts of $[redacted] and $[redacted] for which the income distribution deduction was claimed by the [redacted] for the taxable years [redacted] and [redacted], respectively, were reported on Schedule E of the Taxpayers' return for the taxable years [redacted] and [redacted], respectively, and each amount was clearly identified on each of the Taxpayers' returns (by name and FEIN) as coming from the [redacted]. There is no mention of the [redacted] on either of the Taxpayers' [redacted] or [redacted] returns. [redacted] listed his occupation as "[redacted]" on each the Taxpayers' [redacted] and [redacted] returns.

The address shown on each of the returns of the [redacted], [redacted] and [redacted] for each of the taxable years [redacted] and [redacted] was the same as the address shown on the Taxpayers' returns for those years.

You have estimated that the Taxpayers' have understated their taxable income by over $[redacted] for each of the taxable years [redacted] and [redacted]. You have informed the Taxpayers that you are considering determining deficiencies for the taxable years [redacted] and [redacted] based upon the aforementioned omitted income.

The three year period of limitations under I.R.C. § 6501(a) has expired with respect any deficiencies due from the Taxpayers for the taxable years [redacted] and [redacted]. Because the Taxpayers are farmers and relied on the advice of the promoters of the abusive trust scheme, you do not intend to assert the fraud penalty. You have requested advice as to whether potential deficiencies in income tax due from the Taxpayers for the taxable years [redacted] and [redacted] may be assessed and collected within the six year period of limitations set forth in I.R.C. § 6501(e). While you believe that the Government can show that the Taxpayers' omitted income in excess of 25% of the gross income required to be reported on their return for each of the taxable years [redacted] and [redacted], you have inquired as to whether or not the disclosures on the Taxpayers' returns and the returns of the related abusive trusts were adequate to apprise the Secretary of the nature and amount of the omitted income within the meaning of I.R.C. § 6501(e)(1)(A)(ii). The resolution of this question will determine whether or not the potential deficiencies in income tax due from the Taxpayers for the taxable years [redacted] and [redacted] may be assessed and collected within the six year period of limitations set forth in I.R.C. § 6501(e).

DISCUSSION

Internal Revenue Code § 6501(e)(1) provides in pertinent part as follows:

> (A) General Rule. If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed....at any time within 6 years after the return is filed.
>
> (A)(ii) in determining the amount omitted from gross income, there shall not be taken into account any

> amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

Treasury Regulation § 301.6501(e)-1(a)(1)(ii) similarly provides in pertinent part:

> ...An item shall not be considered as omitted from gross income if information, sufficient to apprise the district director of the nature and amount of such item, is disclosed in the return or in any schedule or statement attached to the return.

The Supreme Court has articulated the basic test which is codified in I.R.C. § 6501(e)(1)(A)(ii) and Treas. Reg.§ 301.6501(e)-1(a)(1)(ii) as follows:

> We think that in enacting [section] 275(c)] Congress manifested no broader purpose than to give the Commissioner an additional two years [now three years] to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage.

Colony, Inc. v. Commissioner, 357 U.S. 28, 36 (1958). The Tax Court has stated that "this does not mean simply a 'clue' which would be sufficient to intrigue a Sherlock Holmes" but "neither does it mean a detailed revelation of each and every underlying fact." George Edward Quick Trust v. Commissioner, 54 T.C. 1336, 1347 (1970), aff'd, 444 F.2d 90 (8^{th} Cir. 1971).

Although I.R.C. § 6501(e)(1)(A)(ii) and Treas. Reg.§ 301.6501(e)-1(a)(1)(ii) require that the information constituting adequate disclosure must be "in the return or in any schedule or statement attached to the return", the Commissioner and the Courts have taken the position that a partner's share of the gross income reported in a partnership information return is considered as having been returned by the partner if the relationship between the partner and the partnership is adequately disclosed on the partner's return. Rev. Rul. 55-415, 1955-1 C.B. 412; Davenport v. Commissioner, 48 T.C. 921 (1967), acq., 1968-2 C.B. 2; Rose v. Commissioner, 24 T.C. 755 (1955), acq., 1956-2 C.B. 8. In this regard, Rev. Rul. 55-415, 1955-1 C.B. 412 states,

> It is well recognized that gross income, as earned, belongs to some taxable entity, and that a partnership is not a taxable entity. It logically follows that the partners should be considered as the owners of partnership gross income....
>
> .... For the purpose of Section 275(c) of the Internal Revenue Code of 1939 'gross income' of a member of a partnership includes his proportionate share of the gross income of the partnership. Any partner's share of the gross income reported in the partnership information return is considered as having been returned by the taxpayer, as such information return is a return by or on behalf of each partner.[1]

The same rule has been held to apply in the case of subchapter S corporations. Roschuni v. Commissioner, 44 T.C. 80 (1965), acq., 1965-2 C.B. 6; Gmelin v. Commissioner, T.C. Memo. 1988-338. As the above-quoted excerpt from Rev. Rul. 55-415 and a review of these cited cases reveals, a partner or subchapter S shareholder is treated as having reported on his individual return his share of the gross income reported on the partnership or subchapter S corporation return because a partnership or subchapter S corporation is a nontaxable entity and the return of such entity is an information return filed by or on behalf of each partner or subchapter S shareholder.

The Taxpayers take the position that, like a partner in a partnership or shareholder of a subchapter S corporation, a grantor or beneficiary of a trust should be treated as having reported the grantor's or beneficiary's share of gross income reported on any trust return from which trust the grantor's or beneficiary's share of net income is reported on the grantor's or beneficiary's individual return. Since [redacted] net income was reported on each of the Taxpayers' returns and the omitted income at issue was reported on each of the [redacted] and [redacted] returns, the Taxpayers assert that the omitted income has been adequately disclosed under I.R.C. § 6501(e)(1)(A)(ii) and, therefore, that the statute of limitations bars assessment and collection of deficiencies due from the Taxpayers for the taxable years [redacted] and [redacted].

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[1] Sec. 275(c) of the 1939 Code is the predecessor of Sec. 6501(e) of the 1954 Code.

In a case involving facts similar to the facts herein, the Tax Court has upheld the six year statute in a case involving abusive trusts. Sampson v. Commissioner, T.C. Memo. 1986-231. In holding that the notice of deficiency was timely issued within the period of limitations provided in I.R.C. § 6501(e), the Court in Sampson reasoned as follows:

> Here, even assuming that the Trust returns are properly considered, petitioners' disclosure of the fact of income from the Trust was not sufficient to give respondent a clue as to the existence of additional omitted income. Neither the Trust returns nor petitioners' individual returns disclosed the fact that William was purportedly employed by the Trust as an independent contractor. The Trust returns did state that the Trust was engaged in a business, but did not identify which business it was engaged in. The only hint which respondent had that petitioners had omitted items of gross income was the fact that William's profession was listed as osteopath on petitioners' 1976 income tax return and yet there was no entry for income from salary or wages or trade or business income. We decline to find that this was a sufficient "clue" as to the existence of the omitted income. Sampson, at p. 1152

Like the taxpayers in Sampson, on their individual returns, the Taxpayers herein have disclosed the fact of their receipt of income from the [redacted]. Similar to the taxpayers in Sampson, [redacted] reported his occupation as farming, but rather than report income from farming on Schedule F, the Taxpayers reported income from "[redacted]" on Schedule F of their [redacted] return and reported no Schedule F income on their [redacted] return. Like the trust return in Sampson, while the [redacted] and [redacted] returns reported the omitted income, neither the [redacted] nor [redacted] returns disclosed that [redacted] performed the farming services which generated the farming income reported on the [redacted] returns. Without the disclosure of this fact, the Commissioner would have no basis to attribute the income reported on the [redacted] and [redacted] returns to the Taxpayers. While there are some differences in the facts disclosed on the returns in Sampson from the facts disclosed on the returns herein, we do not believe the factual differences are material. Like the returns in Sampson, the returns herein arguably provide a hint of omitted income, but do not provide a sufficient clue as to the existence of the omitted income. In our opinion, a Court would likely find that, even assuming the trust returns are properly considered, that the information reported on the returns was not sufficient to apprise the Commissioner of the nature and amount of the omitted income within the meaning of I.R.C. § 6501(e)(1)(A)(ii) and Treas. Reg.§ 301.6501(e)-1(a)(1)(ii).

Although Sampson assumed that the trust returns therein were properly considered for purposes of I.R.C. § 6501(e)(1)(A)(ii), the Court's finding that the mere reporting of the fact of the income from the Trust was not a sufficient disclosure suggests that, if faced with the issue, the Tax Court would likely hold that a grantor or beneficiary of a trust is not treated as having reported the grantor's or beneficiary's share of the gross income reported on a related trust return. As discussed above, if a partner or subchapter S shareholder reports his share of the net income from a partnership or subchapter S corporation on his individual return, he is considered as having reported his share of the gross income reported on the related partnership or subchapter S return. If the Court in Sampson believed that the same rule applied in the case of a trust, the Court should have held that, by virtue of reporting their share of the net income from the trust, the Sampson taxpayers were considered as having reported their share of the gross income reported on the related trust return. Accordingly, the Court's holding that the mere reporting of trust net income was not adequate disclosure suggests that the Tax Court would likely hold that a grantor or beneficiary of a trust is not treated as having reported the grantor's or beneficiary's share of the gross income reported on a related trust return.

As discussed above, a partner or subchapter S shareholder is treated as having reported on his individual return his share of the gross income reported on the partnership or subchapter S corporation return because a partnership or subchapter S corporation is a nontaxable entity and the return of such entity is an information return filed by or on behalf of each partner or subchapter S shareholder. In our view, a grantor or beneficiary of a complex trust should not be treated as having reported the grantor's or beneficiary's share of the gross income reported on a related trust return because, unlike a partnership or subchapter S corporation, a complex trust is a separate taxable entity. Our view is supported by the Sixth Circuit's opinion in Corrigan v. Commissioner, 155 F. 2d 164 (6th Cir. 1946). In Corrigan, the Court held that the beneficiary of a trust was not treated as having reported the gross income reported on the trust return of which she was a beneficiary and, therefore, assessment and collection of a deficiency attributable to her failure to report income from the trust resulting from the disallowance of deductions of the trust could be made within the period of limitations of former I.R.C. § 275(c). Corrigan, supra.

In summary, the disclosures on the Taxpayers' returns did not provide a sufficient clue as to the existence of the unreported income. Sampson, supra. The only reference to the trusts on the Taxpayers' return is to the [redacted] Trust which was a complex trust, a separate taxable entity. Corrigan, supra. Because the [redacted] Trust was a separate taxable entity, the Taxpayers' should not be treated as having reported their share of the gross income reported on the returns of the [redacted] Trust or the [redacted] Trust. Sampson, supra; Corrigan, supra. Accordingly, in our opinion, the potential deficiencies in income tax due from the Taxpayers for the taxable years [redacted] and [redacted] may be assessed and collected within the six year period of limitations set forth in I.R.C. § 6501(e).

If you have any questions concerning this matter, please do not hesitate to call Attorney James M. Cascino at (312) 886-9225 ext. 338.

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